[C] INTERVIEW:Societe Generale economist sees MPC lenient to higher CPI

Cogencis, Monday, Oct 24

By Siddharth Upasani and Bhaskar Dutta

NEW DELHI - The Monetary Policy Committee's maiden resolution looks like a clear "regime shift" towards tolerance for higher levels of inflation, according to Kunal Kundu, India economist at Societe Generale Corporate & Investment Banking, a global investment bank.

One of the primary indicators of this change, Kundu said, is the lowering of the comfort level for real interest rate to 1.25% from 1.50-2.00%.

"Essentially, lowering the real policy rate under the current circumstances is possibly understandable. But it's quite a drastic lowering of expectations," Kundu told Cogencis in an interview.

At its post-policy media briefing earlier this month, RBI Executive Director and MPC member Michael Patra said the global trend of falling interest rates meant that India's real interest rate was probably around 1.25%. This was a downward revision from the 1.5-2.0% thumb-rule the central bank maintained under the previous governor Raghuram Rajan.

In conjunction with the RBI's March 2018 deadline to bring down Consumer Price Index inflation to 4% being superseded by the government's five-year inflation target, the lowering of the real interest rate thumb-rule is a signal of comfort with a higher level of inflation, Kundu said.

The Oct 4 unanimous verdict of the rate-setting committee to cut the repo rate to 6.25% at a time when the market expectations from the policy were largely split also vindicates the regime shift. "I was in the no-cut camp... But the MPC's decision was unanimous. So that to me again is possibly an indication of a regime shift--a shift in regime which will possibly tolerate higher inflation," he said.

Following the rate cut, Kundu has revised his expectations of further easing, and he now expects another 25 bps reduction in the repo rate in Jan-Mar, as against the earlier projection of Apr-Jun.

While it may have cut interest rates, the committee's signals on growth and inflation have been far from clear.

"When you look at the kind of discussion the governor had with economists before the policy meeting, he clearly expressed his concern about growth, and not inflation," Kundu said. "But when you look at the monetary policy statement, the governor is quite gung-ho about growth. He sees growth from many angles, while he sees upside risks to his 5% inflation target."

Patel's closed-door meeting with select economists in late September turned the market's assessment about his policy stance on its head, with his previously hawkish image transforming into one of a dove.

While announcing the rate cut, the committee said the momentum of growth was "expected to quicken", and at the same time, it continued to see upside risks to its 5% target for headline retail inflation.

ONE-LEGGED ECONOMY

Kundu said the rural consumption, despite sufficient rainfall this year, is yet to pick up, forcing the economy to "run on one leg"--highly leveraged urban consumption. And there lies the risk to the economy.

"There is a lot of leveraged demand. So it is this consumption that is as of now the driving force for the economy... Any which way you look at it, there is hardly anything that's happening on the investment front," Kundu said.

But given the difficult fiscal math the government faces for the remaining period of 2016-17 (Apr-Mar), Kundu sees little hope of capital expenditure from the public sector rising.

Some of the major sources of revenue for the government have stuttered. The recently-held telecom spectrum auctions saw a shortfall of around 320 bln rupees. The progress on divestment has been painstakingly slow. The government aims to raise 565 bln rupees from divestment, including 205 bln rupees from strategic stake sales, in 2016-17, but has only managed to rake in about 64 bln rupees so far.

As such, Kundu expects a "substantial" shortfall in the government's

Budget aim for non-tax revenue of 3.23 trln rupees. He, however, expects the government to meet its target of containing fiscal deficit at 3.5% of GDP at the cost of capital expenditure since politically it is the "least sensitive" expenditure.

Calling for a shift in India from a consumption-driven economy to an investment-led one, Kundu said it was critical for the government to not shelve its plans for capacity expansion even at the cost of minor fiscal slippage.

"It's okay for the government to miss the fiscal deficit target by a few basis points, maybe 10-20 bps," he said. "But if you get bogged down by these numbers and capex is hit, then the overall growth can be challenged."

Private investment, on the other hand, is stuck in a vicious cycle. While investment demand is weak due to the slack in the economy, the pile-up of non-performing assets has made banks wary of lending, particularly to the infrastructure sector. As a result, banks are increasingly focusing on the retail segment to boost their bottom-lines, thereby reinforcing the consumption economy.

As on Aug 19, banks' credit to industries was down 0.2% from a year ago, while personal loans were up 18.1%.

While domestic consumption has helped the economy, the global demand for Indian exports offers no such support. While exports rose 4.6% year-on-year in September, it was only the second such rise in 22 months. Many sections have suggested a move to boost the export demand by weakening the rupee.

However, Kundu is sceptical of such a strategy, which he believes will only lead to "a race to the bottom."

"It might help initially, but the key is productivity. To improve productivity, you need a lot of investments... he said. "And investments will happen when foreigners have confidence in the currency."

While global growth remains a concern, the upcoming US presidential elections and the possibility of the Federal Reserve raising interest rates in December may lead to occasional bouts of short-term volatility in the domestic currency market, Kundu said.

However, over the medium-to-long term, the rupee stands to benefit from India's status as one of the fastest growing large economies.

Moreover, Indian debt remains a lucrative destination for return-hungry investors, as aggressive easing measures by central banks in Europe and Japan have pushed much of the global yield curve into the negative interest rate territory.

"The search for yield remains so high that for an economy which is expected to grow at a fast pace relatively, the flows will be supportive of the currency," Kundu said. End

Edited by Arunkumar K.

Cogencis Tel +91 (11) 4220-1000
Send comments to feedback@cogencis.com

.